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by
Eduard J. Bomhoff

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Monetary reform in Eastern Europe

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1. Currency convertibility

Over the past months, the case for currency convertibility in most current account transactions appears to have been won in all the smaller nations of Central and Eastern Europe.¹ It has been accepted that convertibility will help to bring a distorted domestic relative price structure more in line with world prices. The substitution effects both in production and consumption that are activated by the move to convertibility of the currency will be helpful in the transition to a market economy. But, to impose domestic relative prices that are more in agreement with world market conditions will initially impose heavy adjustment costs on consumers and producers. The benefits of more realistic prices do not appear immediately; the costs of reduced subsidies to consumers and producers hurt directly. For that reason alone, removal of distortions in relative prices will stimulate strong political opposition from consumers, workers and managers. A very important advantage of currency convertibility is that the speed with which domestic relative prices adjust to conditions in the world market depends less on domestic political conditions, but is to an extent imposed from abroad.

The other argument from political economy in favor of immediate convertibility on current account is that the absence of an 'economic' market for foreign exchange implies the continued existence of a political market in which foreign currency receipts are collected from companies and allocated to companies (and individuals). Some (small, newly established) companies may have attractive investment projects but fail to obtain foreign exchange for vital imports of machinery, as other (large) businesses enjoy the political

¹See Genberg (1990) for a clear analysis why it makes no sense in the case of the ex-socialist nations to demand that macroeconomic stabilization is achieved before the step to a convertible currency is taken. See also Greene and Isard (1991) for a thorough survey of the arguments for and against quick establishment of convertibility.

connections that are essential to obtaining foreign exchange. In addition, firms and individuals will have strong incentives to maintain foreign currency balances abroad where they cannot be subjected to confiscation or forced exchange into domestic money at an exchange rate less favourable than the black market rate. Maintaining administrative control over the foreign exchange market will perpetuate an uncertain and inefficient set of constraints on firms' activities and cause allocative distortions to spread from the foreign exchange market to the domestic goods and credit markets.²

2. Fixed exchange rates or a crawling peg?

Many economists have advocated some form of fixed exchange rates for the Central and Eastern European nations. Prescriptions vary from Allan H. Meltzer's³ advocacy of a monetary authority for the Soviet Union along the lines of the Hong Kong example to proposals to strive towards participation in the European Monetary System near the end of this decade. A fixed exchange rate has also been advocated as part of a fiscal-monetary package to break (incipient) hyper-inflation.

Fixing the exchange rate of a bankrupt economy without substantial gross international reserves will result in an exchange rate that should deliver almost instantaneous equilibrium on current account. That exchange rate will – unavoidably – be severely undervalued by any purchasing power parity consideration. The actual value of the real exchange rate, however, will depend, *ceteris paribus*, on the emphasis the authorities put on maintaining the fixed exchange rate. The longer the period for which the authorities aim to continue a particular exchange rate, the lower the exchange rate will move in the black market just before being fixed by the authorities at that black market rate. For, the markets will assume continued domestic inflation as price reform takes place and monetary overhang is reduced. Also, political pressure during the period of fixation of the exchange rate may lead to nominal wage increases in the government sector in order to temporarily lower the speed of decline in real wages. Finally, fiscal reforms may fail and the government may have to print money to cover part of its deficit. In order to maintain a low probability of an imminent devaluation throughout such a period, the exchange rate must be so low that initially international reserves will be accumulated through current account surpluses. This, in fact, is what happened in the Polish case.

An extremely low exchange rate may indeed achieve credibility that it will be maintained for a protracted period. That by itself does not deliver a nominal anchor to the economy: in Poland inflation continued at a 100

²Calvo and Frenkel (1991) usefully analyse the difficulties in developing credit markets in ex-socialist nations during the transition to a market economy.

³See Meltzer (1990), see also Bofinger (1991) and Bomhoff (1991) for a critique.

percent annual rate after the initial 80 percent jump in average prices after the currency reform. A long-term fixing of the exchange rate has significant costs, as the ablest workers contemplate migration, given the extreme disparity between domestic and foreign wage levels. With a crawling peg – fixing the exchange rate for briefer periods – the exchange rate will be able to depreciate as necessary, avoiding the need for an initial value that is as low as in the recent Polish case.⁴

The standard objection to a crawling peg as initial exchange rate system for the ex-socialist nations is that the economy then needs to derive its nominal anchor from its own domestic monetary target, but that the demand for money schedule is too uncertain to make this feasible during the transition to a market economy: monetary overhang, future price reform, uncertain trends in real income and wealth, uncertain returns on money substitutes. The objection seems valid, but there is an alternative. With most workers employed by the state, setting a path for nominal wages in the state sector during the initial period of the reforms will deliver something akin to nominal income targeting. This in fact is what the Dutch finance minister, Pieter Liefstinck, did during the first 6 months after the Dutch currency reform of July 1945: the government executed a wage policy and the Central Bank was instructed to increase the money supply accordingly.⁵ In December 1945, the monetary overhang had been removed, real income could be estimated with more accuracy than directly after the war, and the Central Bank moved successfully to a standard monetary policy of steering a monetary aggregate.

3. Monetary reform in the Soviet Union

Two factors make it even more difficult to offer some suggestions about the Soviet Union than to consider the smaller nations of Central and Eastern Europe. First, potential conflicts between different nationalities create the real risk of territorial conflicts between the different republics, perhaps especially in the smaller Asian republics where population pressures cause incompatible demands for scarce water resources. Second, uncertainty about fiscal policy is an order of magnitude greater than in the smaller countries of Central Europe: tax revenues are collected at the republican level, but military expenditures and much of the bureaucracy is currently financed through

⁴Poland exemplifies the attempt to achieve a credible fix of the exchange rate for a long period. See Portes (1991) for analysis of the costs of an excessive initial devaluation as in the Polish case. Asselain (1991) writes: 'the level of the exchange rate may be considered a weak point of the (Polish) plan adopted in autumn 1989.'

⁵See Liefstinck (1973); Bomhoff (1991) paper summarizes this episode.

the centre.⁶ The chaotic situation in the fiscal area and large differences in per capita wealth imply that each different republic is going to implement its own tax system. This is not to be regretted, as the traditional Hayekian argument applies that trying different systems during the difficult transition to a market economy may make more sense than imposing a single system of taxation from above.

If a single monetary authority tries to serve all republics and at the same time the republics implement separate fiscal policies, how will such a common monetary authority implement a monetary reform to end the current hyperinflation? Centrifugal political forces will make it difficult if not impossible to negotiate the amount of seigniorage to be collected by a single monetary authority for the Soviet Union, let alone its division over the different republics. More fundamentally, a monetary reform makes little sense unless future budget deficits can be covered without recourse to excessive money creation.⁷ However, the underlying fiscal reforms that are necessary for a successful monetary reform depend on developments in the individual republics, and these will not be coordinated between the republics but depend on political conditions in each republic. Under these circumstances the republics will prefer to maintain monetary autonomy including the right to alter the exchange rate with the other republics. The total amount of seigniorage may be less if each republic introduces its own money, because foreign currency may become even more important for trans-border trade, but each republic will have full rights over its own revenues from the creation of money. If the world community sees negative externalities here, that would be an argument for fiscal assistance to the republics.⁸

Prices will have to be liberalized throughout the Soviet Union and real wages must adapt, but political conditions in each republic will dictate the speed with which the required decline in real wage costs can be implemented. Political conditions in some republics will be more conducive to a rapid fall in real wage costs; other republics will feel obliged to move more slowly and such differences in the speed with which price reform and privatization take place will have consequences in the fiscal area. Not only will the republics not be able to agree on a common monetary policy, they will not want to give up the exchange rate as an instrument for macroeconomic adjustment.

In the meantime, one has to hope that real activity in each republic will not be disadvantaged by the introduction of separate monies in the republics and that republics will not be tempted to impose costly restrictions on

⁶This chaotic state of affairs makes it impossible to produce an aggregate estimate of the current budget deficit for the Soviet Union. A number of 25 percent of GDP has been mentioned.

⁷Bruno (1991) describes how Israel and some Latin American countries lost their nominal anchors because of fiscal imbalances in conjunction with (partial) wage indexation.

⁸See Solimano (1991) for an analysis of fiscal assistance by the league of nations to Central and Eastern Europe in the interwar period.

interrepublican trade. Transaction costs will unavoidably increase temporarily as economic agents have to learn to use new monies without a reputation or a record, and to assess the costs and benefits of trading in domestic money or in hard currency. Resolution of the uncertainties that lead to higher transactions costs will depend, as always, on fiscal developments, because there never will be a stable monetary policy without a sustainable fiscal policy.

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